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SIPDIS

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SUBJECT: NATION-BUILDING BONDS: SRI LANKA TARGETS ITS CITIZENS LIVING OVERSEAS

REF: COLOMBO 550

¶1. (U) Summary: In a move to raise funds from new markets, the Government of Sri Lanka (GSL) is targeting its citizens living overseas (who normally repatriate over USD 1 billion in remittances annually) to purchase patriotically-branded, Nation Building Bonds (NBB), by offering tax holidays and import duty concessions on vehicles. The NBBs may become a success, as the GSL has already reported a good response from workers in the Middle-East. The bonds appear to be one more way the GSL is trying to reduce its exposure to condition-laden, traditional donor financed concessionary debt. End Summary.

NBB - GSL LOOKING FOR FRESH FINANCING SOURCES

¶2. (U) The 2006 GSL deficit (in nominal terms) is projected to increase by 23 percent to Rs 247 billion (approximately $2.5 billion), equivalent to 9.1 percent of anticipated 2006 GDP (compared with 8.6 percent of 2005 GDP) (reftel). This increase stems from a sharp rise in both recurrent and capital expenditure. Traditionally, Sri Lanka has sought concessionary funds from international institutions such as the International Monetary Fund (IMF). For example, Sri Lanka was offered the possibility of borrowing, through the IMF, approximately USD 413 million from a three-year Poverty Reduction Growth Facility (PRGF) and an Enhanced Fund Facility (EFF) arrangement approved in 2003. Although the PRGF and EEF were scheduled to expire on April 17, 2006, Sri Lanka already abandoned these programs, having drawn only USD 59 million from them, when the previous Government (comprised of the same party as the current Government) took over from the more liberally-minded Government that initiated the PRGF in 2003. The GSL must now seek new lenders.

¶3. (U) On February 4, the Central Bank floated foreign currency denominated "Nation Building Bonds" and invited Sri Lankan workers abroad to invest (Note: Sri Lankan expatriates typically remit over USD 1 billion per year. End Note). The NBBs follow the pattern of bonds issued by India to its diaspora. It is a much smaller issue than the recently announced sovereign bond issue which is expected to bring in up to USD 1 billion (reftel). Unlike the sovereign bond, NBBs do not target international financial institutions. The Government hopes to raise a maximum of $250 million through this mechanism. The first issue of $25 million is now open for subscription. The state-owned Bank

of Ceylon is the lead manager for the issue. The issue is open for six months until August 2006.

COMPLEX CONCESSIONS

¶4. (SBU) The GSL is offering interest rates similar to prevailing government bond rates in the US and the UK. This is quite significant, given how relatively low the rates are on USG treasuries and UK gilts, and considering the inherently higher risk premium Sri Lanka sovereign debt may be expected to carry, as indicated by its sovereign credit risk rating (currently sub-investment grade). But the deal is significantly sweetened with tax and duty concessions. Under the NBB scheme, bondholders can reduce import duties on vehicles from over 100% to 25% of the vehicle's import value. In order to be eligible for this reduction, bond purchasers must invest at least $50,000 in NBBs and the Cost, Insurance, Freight (CIF) value of the car can be up to 20% of the value of the bond. Therefore, a $10,000 vehicle that would typically cost a Sri Lankan a minimum $20,000 (after import duties and other taxes) will cost only $12,500 if $50,000 of NBBs are purchased.

¶5. (SBU) Expressing concern over the NBB's duty concessions on motor vehicles, Dr Rani Jayamaha, Deputy Governor of the Central Bank, told EconOffs that there will be opportunities for misuse. She acknowledged that a straight-forward bond issuance would have been much more manageable.

MARKETING WITH PATRIOTISM, BUT NOT SPECIFYING PROJECTS
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¶6. (SBU) When he first announced the issuance on February 3, Finance Secretary P.B. Jayasundera did not specify how this extra debt burden would be used, beyond saying that the NBBs would be used for infrastructure projects. Although a seasoned public finance expert, Jayasundera gave a surprisingly trivial (and false) justification for the issuance by saying "we don't need the money. But there are some patriotic people out there who want to share in the national building process." While the GSL has yet to publicly name specific projects, Central Bank Deputy Governor W.A. Wijewardena told EconChief that the bonds will be used for such infrastructure projects as construction of an airport in Hambantota (in the far south) as well as power sector and road development.

¶7. (SBU) An increasingly frustrated Jayasundera appears to be making strong efforts to wean Sri Lanka off concessional but condition-based donor debt. Sri Lanka's efforts to obtain a sovereign bond rating (which they achieved in December 2005), its rejection of traditional IMF and WB financing facilities and its use of this latest scheme all speak to an effort to raise money, but with little or no strings attached.

¶8. (SBU) Since Jayasundera's February 3 announcement, the GSL has re-adjusted its NBB marketing strategy, although still playing on patriotism (or at least duty to country). Newspapers quoted Assistant Central Bank Governor Rose Cooray, kick starting a NBB marketing campaign in the Middle East, as saying "We want to tell the Sri Lankan expatriates of the country's expectations from its people toward national building."

¶9. (SBU) Deputy Governor Wijawardena also told EconChief in March that the GSL has received a good response for these bonds from Sri Lankan workers (typically blue collar) in the Middle East, although there has been less demand by Sri Lanka's professionals living abroad.

¶10. (SBU) In 2004, the GSL targeted the private market with

its Sri Lanka Development Bonds (SLDB) of which there were USD 261 million outstanding at the beginning of 2005 (provisionally USD 254 million at the beginning of 2006). Unlike the NBBs, only foreign individuals and companies and Sri Lankans living outside Sri Lanka are permitted to purchase the SLDBs; yet the SLDBs are listed as domestic debt. The NBBs issued will have a further impact on the GSL debt structure, reducing its foreign concessional debt with debt of a more commercial nature.

Comment

¶11. (SBU) In addition to the reftel sovereign bond issue, the Nation-Building Bond reflects substantial borrowing from international markets and an attempt to pursue non-traditional sources. While the wisdom of issuing bonds with complicated incentive structures can be questioned, the cash raised could do some good if used to fund public investment that will benefit the economy, and not pay for ever-increasing subsidies or the ballooning civil service. This appears to be one more step down the GSL's path of reducing its dependence on donors, in favor of commercial borrowing, in an effort to throw off what Jayasundera sees as overly restrictive donor conditionality. End Comment.

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